State of Alaska
Department of Revenue
State Investment Review Meeting
May 10, 2022

MEETING SUMMARY

Meeting Details:
Start Time: 10:00 AM End Time: 11:15 AM

Department of Revenue Staff present:
Lucinda Mahoney, Commissioner of Revenue
Zachary Hanna, Chief Investment Officer
Pamela Leary, Director of Treasury
Shane Carson, State Investment Officer
Casey Colton, State Investment Officer
Scott Jones, Head of Investment Operations, Performance & Analytics
Ryan Kauzlarich, Accountant IV
Hunter Romberg, Investment Data Analyst
Alysia Jones, ARMB Liaison Officer

Investment Advisory Council (IAC) Members present:
William Jennings
Jerrold Mitchell
Ruth Ryerson

I. Introduction

Mr. Hanna reviewed the agenda, noting that it was pretty straightforward despite all the market activity.

III. State Investments

Mr. Hanna commented that there was a pretty dramatic reversal between Q1 2022 and what they saw in the Q4 2021. He then provided an economic and market update touching on the economic recovery and how the Russian/Ukraine crisis acted as catalyst, shaking up the market in a number of ways.

Mr. Hanna discussed the Fed response to try and control inflation and the material impact of their actions on the economy and capital markets.

Mr. Hanna then reviewed the period table of returns, noting everything had negative returns except cash at zero in the 1st quarter.

A. March 31, 2022 Performance – Commissioner's Report

As of March 31st, the Commissioner was fiduciary for $7.3 billion in state assets. The larger funds include the Constitutional Budget Reserve (CBR), the two general fund accounts – GeFONSI I and GeFONSI II, the power cost equalization (PCE) fund, and the public schools trust fund.

Mr. Hanna stated that all of these funds would be covered during the asset allocation portion of the agenda and directed the group's attention to the relative asset allocations which reflected how they ended the quarter versus what the targets were.

All deviations were low with the majority between 20 and 30 basis points. The one exception was of the Alaska Student Loan fund, which is on a two-year path to increasing risk.

Looking at performance by asset class building block, Mr. Hanna explained that all the funds' performance stems from these underlying core building blocks. He said fixed income was down 5.8%, domestic equities 5.28%, and both international equities and REITS were down 5.44% for the quarter. He added that all outperformed their indexes by 6-10 basis points.

Mr. Hanna also walked through the fiscal year to date performance, commenting that the equity heavy portfolios had negative performance, but were better than more moderate portfolios that had more bonds like EVOS. He added that was not a normal expectation and indicated it was an artifact of the strongly positive correlation between stocks and bonds in a negative market.

Mr. Hanna noted that low risk funds like GEFONSI I and II had negative performance of -92 bps and -1.49 bps despite lowering their risk profile last year.

B. Non-Routine Investments

Non-routine investments are investment opportunities that fall outside the scope of the Department's existing investment opportunity set.

Mr. Hanna stated that Department does not currently have, nor is presently contemplating any non-routine investment opportunities.

In the event such an opportunity arises, a summary of the robust non-routine investment process is included in each SIR meeting packet and non-routine investments remains a standing item on the quarterly meeting agendas.

C. Asset Allocation Process & 2022 Capital Market Assumptions

Mr. Hanna explained that staff annually review and make recommendations for the asset allocation process taking into account specific investment objectives, risk tolerances, and other attributes. The Commissioner then uses that information to set investment policies and asset allocations for over $7 billion in state assets, pooled into 25 funds with similar mandates.

Mr. Hanna characterized the remainder of his presentation as their initial thinking and the degrees of freedom that they were using. He noted that some elements were budget focused and would not be completed until June.

Mr. Hanna explained for FY23 they planned to continue with the same four core asset classes they used in FY22; domestic equities, international equities, core fixed income, and cash equivalents. They also planned to continue with REITS and tactical bonds, as both have been additive in FY22 from a return perspective.

Mr. Hanna discussed two other changes currently being evaluated. One was adding a shorter duration government/credit1-3 year portfolio for shorter time horizon funds. The second was adding some internally managed S&P index funds to the SOA equity pools.

Dr. Jennings commented that S&P had better press, and that Russell was more obscure, but that there was a separate marketing reason to have that be part of their "quiver of arrows". Mr. Hanna responded that there were some embedded factor elements related to how S&P manages it and how we would weight it.

Mr. Hanna then reviewed the risk tolerance framework and reminded the group that they had added a magnitude of loss element to the framework in response to the low rates seen over the past couple of years. He noted that they would largely revert back to using probability of loss as a primary downside metric, given that rates were higher, but that the value-at-risk would continue to be utilized to inform their fiduciaries of potential magnitude of downside risk.

Mr. Hanna asked if anyone was aware of a way to describe the risk tolerance continuum that would better span the spectrum and allow them to communicate the level of risk tolerance more easily. There was no response.

Mr. Hanna said they use Callan's capital market assumptions for the long-term funds and then blend that with current rates for shorter-term asset allocations to bridge the time horizon gap.

Mr. Hanna explained the 10% probable annual loss, which represented the expected shortfall or loss in 1 out of ten years. He added that they also included the 5% shortfall numbers, which may be closer to what they are seeing in the markets this year.

Mr. Hanna explained the Higher Ed Fund was a 70/30 endowment that was being swept into the CBR and there had been some court rulings back and forth as well as discussions with the legislature. He said that they were in the process of getting final guidance on how and when to sweep that back into the funds.

Mr. Hanna then reviewed all state funds by risk tolerance level, discussing current asset allocations, and providing updates as to where staff were with their evaluations and recommendations.

Commissioner Mahoney asked about the steep increase in interest rates. Mr. Hanna responded that his understanding of the Fed comment was that the market expectation last week was that the next two meetings would see 50 bps increases each meeting. He added that the expectation today was 7.4 percent interest hikes between now and the end of the year.

IV. IAC Comments

Dr. Jennings suggested that if there was any hesitancy over the reallocation and tactical bond allocation, that they re-run the optimizations with more leeway to allocate to them. He believed that they would be more attractive in the optimizer and that may provide additional assurance that those are good approaches to have.

Dr. Jennings noted that given the volatility of this year, it would be prudent from a procedural perspective to ask Callan if they had they updated the capital market assumptions.

Dr. Jennings also suggested a double check to ensure no particular fund was being advantaged from being in the wrong bucket.

In regard to the timeline for the Higher Education Fund, Dr. Jennings said what jumped out to him was that they were essentially talking about dollar cost averaging out. He said if they pull out of the equity markets too soon they were not going to see those rebounds and numbers versus if they were dialing up in equity allocation and bought right before the crash, that would be in their records forever. He discussed rational finance and behavioral finance approaches., and said he ultimately agreed with Mr. Hanna's fast action approach.

Mr. Hanna said they were big fans of dollar cost averaging and viewed it as a way to minimize policy risk when they have reasonable time horizons. He added that if they were to dollar cost average this fund, they would need to determine what their time window was.

Ms. Ryerson asked why the Higher Education Fund was being rolled into the General Fund. Mr. Hanna and Ms. Leary explained the repayment requirement for the CBR, commonly referred to as the "sweep" and reverse sweep policy. Ms. Leary explained that there was a lot of discussion last year about whether the Higher Education Fund was a fund to be swept and that the current determination was that it was able to be swept and would be moved into the CBR.

Ms. Ryerson thanked them for the explanation and said that based on the information she agreed with the way staff was proceeding.

Dr. Mitchell commented on the care and professionalism of the staff's review of the funds and said he would also act quickly with the move.

Dr. Mitchell then said he thought inflation was ahead of the Fed and that the Fed announcing what they plan to do was not helping. He suggested a Paul Volcker approach so that people would take it more seriously. He added that he keeps scratching his head on the differences between the actuarial and Callan forecasts for inflation and returns, which he believes are correct long term, but do not address the immediate issue investment managers were dealing with on a day-to-day basis. He said the question was whether this is another normal correction or the bursting of a very large bubble. He said he believed there was a serious inflation problem that would only be solved by higher rates and recommended that everyone be ready for it.

Commissioner Mahoney thanked the IAC members for their comments and said it was nice to hear that all three agreed on moving quickly on essentially the liquidation of those equities and getting them into a cash equivalent type fund.

V. Future Agenda Items & Calendar Review

Mr. Hanna reviewed potential topics for the upcoming meeting.

The next meeting is scheduled for August 23, 2022.

VI. Other Matters for Discussion – None.

VII. Adjournment

There being no further items for discussion, the meeting adjourned at 11:15 a.m.